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SUBJECT: WORLD FINANCIAL MARKET VOLATILITY ROCKS BRAZIL IN
SHORT TERM

SAO PAULO 00000709 001.4 OF 002

11. (SBU) Summary: The global financial turmoil resulting from losses in global credit markets as well as concerns about the US sub-prime credit market have hit Brazilian assets hard over the last several days. BOVESPA, Brazil's principal stock market, registered declines of more than 15 percent since the beginning of August due to capital flight from international investors. In addition, stock market declines have put downward pressure on the country's appreciating currency. Over the short-term, Consulate General financial contacts expect the volatility to continue; however, they are cautiously optimistic that Brazil's economic fundamentals remain strong enough to weather any short-term fluctuations. Brazil may in turn benefit over the medium-term by demonstrating to international investors the country's resilience to external financial shocks. End Summary.

Brazil Taking a Big Hit in the Short Term

12. (U) On August 16, BOVESPA suffered its worst performance since April, falling by more than 8 percent before rallying to close down nearly 3 percent. The combined market value losses for Brazilian companies total more than \$270 billion USD and the currency has depreciated by more than 11 percent in August alone. While liquidity in the Brazilian stock exchange encourages international investors and has been a key factor in driving down the country's risk premium, Brazilian assets suffered extensive impacts from the worldwide global financial turmoil as international investors moved out of the market. The country risk premium, which measures the market's confidence in the country, reached 229 points on August 16 (a significant increase from just a few months ago), and is now at Brazil's highest level since December 2006. Mauricio Oreng, the Vice-President for Economic Research at Banco Itau, one of Brazil's top banks,

told Econoffs that one of the reasons Brazil has seen such an impact is because Brazil's higher stock market trading volume facilitates the quick withdrawal by international investors that are opting to cash out of emerging market assets.

Short-term Volatility Likely to Continue

13. (SBU) Brazilian financial market analysts are unaccustomed to the extreme fluctuations worldwide financial markets experienced in the first part of August. While the Brazilian currency and stock market indices have steadily increased over the past few years, the rapid swings surprised local market analysts. Local financial analysts told the US Treasury Financial Attache that they expect volatility to be high for the foreseeable future and that it is impossible to predict when markets will calm down.

14. (SBU) Starting on August 14, the Brazilian Central Bank refrained from buying up dollars to curb the Brazilian currency's appreciation vis--vis the US dollar. This decision not to intervene in the currency market was the first time the Brazilian Central Bank has made this decision in over a year. Banco Itau told Econoffs the Central Bank likely opted against intervening as a sign to encourage market self-regulation and to increase market confidence over the long-term in the floating exchange rate regime. Itau believes Brazil's Monetary Policy Committee's (COPOM) recent trend of reference interest rate cuts is unlikely to continue over the short-term, and stock traders in Sao Paulo told the Attache that local reaction suggests no major shift in expectations at its upcoming meetings in September and October.

Economic Fundamentals Remain Sound

SAO PAULO 00000709 002.3 OF 002

15. (SBU) Although Brazil's financial market has suffered some significant losses over the last several days, Consulate General financial contacts remain cautiously optimistic. The origin of the sell-off of Brazilian stocks is entirely external, and the country's fundamental economic performance is broadly unchanged. Brazil is one of several emerging market countries that are experiencing an outflow of foreign capital as part of a worldwide market reaction, which indicates investors are not differentiating between the various emerging markets. Contacts believe the markets will eventually correct themselves. Brazilian stock traders told the Attache that valuations now look much more attractive than before when emerging markets had experienced large price appreciations, and the decline over the last week may bring prices closer to more sustainable levels and encourage some investors to start buying Brazilian stocks.

16. (SBU) Brazilian financial and economic analysts generally agree that the recent volatility is unlikely to affect the country's economic performance over the medium term. Financial analysts told the Attache that they have no reason to fear an economic crisis given Brazil's economic fundamentals. Brazil's trade balance remains sharply positive around \$45 billion USD, and international reserves are at an historic high of nearly \$160 billion USD. Together with the country's improving debt position, the macroeconomic picture seems strong enough to withstand the volatility. Brazil's domestic economy drives the country's economic growth, and because of its diverse export product and market base, Brazil's external sector is relatively insulated from a downturn in the US economy. Brazil, however, would likely feel the secondary impacts of a worldwide slow-down in economic growth.

Comment

17. (SBU) Brazil is well-positioned to overcome the global short-term financial market volatility. Two years ago, Brazil's economic fundamentals may not have been strong

enough to withstand sustained capital flight, however today the country is likely to benefit over the medium-term. The recent movements could help buttress Brazil's quest to win investment grade ratings from the major ratings agencies by the end of 2008. BOVESPA has, at least over the past few months, closely tracked with changes in the Dow Jones (DJ). Should that trend continue, upward movements in the DJ could also portend an upward trend in the BOVESPA. The country's ability to successfully weather extremely volatile market conditions could prove its resilience to external shocks and strengthen perceptions about its economic fundamentals, welcome news to international investors. End Comment.

18. (U) This cable has been coordinated with the US Treasury Attache in Sao Paulo and with Embassy Brasilia.
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